COMMONWEALTH OF VIRGINIA

STATE CORPORATION COMMISSION

AT RICHMOND, OCTOBER 11, 2002

COMMONWEALTH OF VIRGINIA

At the relation of the

STATE CORPORATION COMMISSION CASE NO. PUE-2001-00306

Ex Parte: In the matter of considering requirements relating to wires charges pursuant to the Virginia Electric Utility Restructuring Act

FINAL ORDER

On November 19, 2001, the State Corporation Commission ("Commission") entered an Order ("November 19, 2001, Order") in this docket establishing generation market price methodologies for purposes of establishing wires charges for Dominion Virginia Power ("DVP"), and Appalachian Power Company, d/b/a American Electric Power ("AEP-VA"). Subsequently, on May 24, 2002, the Commission also entered an order establishing wires charge methodologies for Virginia's electric distribution cooperatives[1] ("Cooperatives").

The November 19, 2001, Order, *inter alia*, directed in Ordering Paragraph five (5) thereof, that incumbent electric utilities seeking to impose wires charges in calendar year 2003 and beyond make annual filings by July 1 of each year for any proposed revisions in their fuel factor, "and corresponding

[1] A&N Electric Cooperative, BARC Electric Cooperative, Central Virginia Electric Cooperative, Community Electric Cooperative, Craig-Botetourt Electric Cooperative, Mecklenburg Electric Cooperative, Northern Neck Electric Cooperative, Inc., Northern Virginia Electric Cooperative, Powell Valley Electric Cooperative, Prince George Electric Cooperative, Rappahannock Electric Cooperative, Shenandoah Valley Electric Cooperative, and Southside Electric Cooperative, Inc.

changes in capped rates, and for market price proposals." Ordering Paragraph six (6) of that Order kept this docket open for consideration of other matters concerning market price determinations and wires charges, as they may arise.

On July 1, 2002, DVP and AEP-VA both caused to be filed in this docket, their proposals and testimony of several witnesses for revisions to market prices for generation and resulting wires charges for calendar year 2003. The Cooperatives also made a filing in this docket on July 1, 2002, addressing market price methodologies for purposes of calculating market prices and resulting wires charges pursuant to § 56-583 of the Virginia Electric Utility Restructuring Act (the "Act").[2]

On July l6, 2002, the Commission issued an Order setting a procedural schedule and hearing date for the determination of market prices in conjunction with the establishment of wires charges for incumbent electric utilities in calendar year 2003. Cogentrix Energy Inc., the Virginia Committee for Fair Utility Rates ("VCFUR"), the Division of Consumer Counsel of the Office of the Attorney General, and the Virginia Independent Power Producers, Inc., filed notices of participation as respondents in the case. Only VCFUR filed direct testimony and exhibits on August 12, 2002. On August 28, 2002, DVP and AEP-VA filed rebuttal testimony.

On August 23, 2002, AEP-VA filed a Motion to Strike portions of the prepared testimony submitted by VCFUR's witness, Jeffry K. Pollock. VCFUR responded to the motion on August 30, 2002, and AEP-VA filed its reply on September 3, 2002.

The hearing to receive evidence on the market price determination issues was convened at the Commission on September 4, 2002. Upon commencement of the hearing, the Commission denied

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[2] Title 56, Chapter 23 (§ 56-576 et seq.) of the Code of Virginia, hereinafter referred to as "the Act" or "the Restructuring Act".

AEP-VA's Motion to Strike. Appearances were made by counsel for the Commission's Staff, DVP, AEP-VA, the Cooperatives, VCFUR, and the Division of Consumer Counsel. Testimony was received from Mr. David F. Koogler, Mr. Gregory J. Morgan, and Mr. Kurt W. Swanson for DVP; Mr. Kelly Pearce and Mr. Bruce Braine for AEP; Mr. Mark K. Carsley for the Staff; and Mr. Jeffry C. Pollock for VCFUR.

Witnesses for DVP and AEP-VA testified that the Commission should continue to base the determination of market prices on forward market data with minor modifications necessitated by changing industry circumstances. In his rebuttal testimony filed on August 28, 2002, DVP Witness Koogler also proposed the inclusion of a capacity component into the projected market prices for generation ("capacity adder"), with corresponding changes to DVP's Competitive Service Provider Coordination Tariff ("CSP Coordination Tariff"). VCFUR Witness Pollock testified that the Commission should require DVP and other utilities to project market prices at the retail level, since such prices include the value of capacity needed to meet reliability needs. However, Pollock stated that if the Commission elects to rely on a wholesale market price projection, then additional capacity costs should be imputed so that the projected price is at least equal to the incremental cost of new generation capacity. Pollock also testified that the Commission should docket a proceeding to quantify the stranded costs of each regulated electric utility that is either proposing, or has previously implemented, a wires charge.

NOW THE COMMISSION, upon consideration of the record and the applicable statutes and rules, is of the opinion and finds that the wires charge proposals of DVP and AEP-VA should be adopted, as modified herein, for the 2003 calendar year period.

This matter concerns the annual determination of market prices pursuant to § 56-583 of the Act. The Act directs the Commission to establish wires charges for each incumbent electric utility effective upon the commencement of customer choice. In order to establish such wires charges, the Commission must determine projected market prices for generation and subtract those projected market prices from each utility's embedded generation rate[3].

Section 56-583 of the Act begins with the phrase "[T]o provide the opportunity for competition and consistent with § 56-584…" Section 56-584, in turn, states:

> Just and reasonable net stranded costs, to the extent that they exceed zero value in total for the incumbent electric utility, shall be recoverable by each incumbent electric utility provided each incumbent electric utility shall only recover its just and reasonable net stranded costs through either capped rates as provided in § 56-582 or wires charges as provided in § 56-583.

We have consistently read §§ 56–582 through 56–584 of the Act as establishing the base mechanism that compensates incumbent electric utilities when customers choose to purchase electric service from competitive service providers ("CSP"). Thus, just and reasonable net stranded costs are recoverable by each incumbent utility through the collection of either capped rates or wires charges. Further, in prior orders relating to electric choice proceedings, we have consistently held that the wires charge stranded cost recovery mechanism set forth in the Act essentially makes the incumbent electric utility indifferent as to whether a customer elects to receive electric service from a CSP or remain a generation customer of the incumbent. This remains the pillar supporting our determinations set forth below.

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[3] The embedded generation rate includes fuel costs as determined by the Commission pursuant to § 56-249.6 of the Code of Virginia.

When a customer formerly served by an incumbent electric utility takes electric generation service from a CSP, the incumbent retains control of the electric generation that formerly served the departing customer. Under the Act, this "displaced power" is assumed sold by the incumbent into the wholesale power market. The wires charge mechanism compares the value of this electric generation, as measured by the revenue accruing from the sale adjusted for net transmission costs, to the revenue that the incumbent would have collected from the departed customer. Should the expected revenue garnered from the wholesale sale be less than the retail revenues that would have been collected from the departing customer, the difference between these two values represent wires charge revenues. We determine and set a wires charge rate to allow the incumbent the opportunity to collect this difference. Again, the wires charge collection is designed to leave the incumbent indifferent between these two revenue streams.

Discussion of this basic framework illuminates the issues placed before us for decision in this proceeding. The VCFUR takes issue with key aspects of the controlling statutes. The VCFUR, through its witness Jeffry Pollock, argues that (1) market prices for generation should be based on retail rather than wholesale prices, (2) in the event the Commission decides that wholesale costs are indicated for market price determination, a different method should be employed to determine those wholesale market prices, (3) no deductions for transmission costs should be made from any determined market price, and (4) the Commission should docket a proceeding to quantify the stranded costs of each electric utility that is either proposing or has previously implemented a wires charge.[4]

All of Mr. Pollock's recommendations have the potential to reduce or eliminate the level of wires charges collected by incumbent electric utilities that lose load to CSPs. Mr. Pollock points out that, without the reductions in wires charges that result if this Commission adopts one or all of his recommendations, the prospects for the development of retail competition are dim in the Commonwealth.

We share Mr. Pollock's concern regarding the development of effective retail competition in Virginia. However, we cannot adopt his recommendations. The stimulation of competitive activity by reducing the revenues permitted to be collected by Virginia's incumbent electric utilities is not allowed under the Act[5].

Mr. Pollock also testified that the forward prices were illiquid and that additional revenues could be garnered by the selling of additional generation-related products. While we discuss the selling of additional generation-related products (*i.e.*, the capacity adder) below, we note that Staff, AEP-VA and DVP all maintain that forward market liquidity is sufficient for market price determination purposes. While the turmoil in wholesale electric markets has caused a decline in trading volumes and is certainly a cause for concern, the evidence here indicates that such forward markets remain sufficiently liquid for the task at hand.

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[4] Pollock, Ex. 9 at page 4.

[5] As we stated in our November 19, 2001, Order in this case:

> New Energy stated that such cost adjustments are needed in order to make a fair and equitable comparison of the market price and the utility's price to compare, and that the adjustments would promote competition. We do not disagree that allowing for "headroom" by incorporating retail costs in market prices would fairly recognize the costs CSPs will incur to serve customers, and would likely promote competition. However, it would not be revenue neutral to the incumbent utility.
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> The Act, in our view, is designed to make the incumbent utility whole, with the wires charge priced to make the utility indifferent as to whether it recovers stranded costs through capped rates or wires charges. Including retail costs in the calculation of market prices would not likely leave the utility in a revenue neutral position as the Act is designed to do. We cannot, therefore, find that the Act authorizes such action. If the General Assembly determines that this measure is appropriate to advance competition it, of course, may amend the Act to allow it.

Staff, AEP-VA, DVP and the Cooperatives recommend the continuation of basing the determination of market prices on forward market data with minor modifications necessitated by changing industry circumstances. For facilitating retail choice in 2003 consistent with § 56-583, we will continue to base the Commission-determined projected market price for generation on forward market data generally consistent with the method set forth in our November 19, 2001, Order in this case. The use of *EnronOnline* will be dropped from the calculation. We will also adopt the recommendation of Staff Witness Carsley that, for the purposes of calculating DVP's transmission cost adjustment to market prices, only the most recent twelve months of transmission and ancillary services expenses be considered.

We will require that the base forward market information be collected on the following ten dates: August 19, 2002; August 27, 2002; September 4, 2002; September 12, 2002; September 20, 2002; and September 23 though September 27, 2002;

Below we discuss the two remaining issues in this matter.

Capacity adder

The first issue pertains to whether a separate "adder" reflecting the market value of generation capacity should be added to the market price produced by the forward market based method that will continue to be in use in 2003. In response to requests from CSPs, Staff re-examined the appropriateness of including a separate capacity value in projected market price determinations for 2003. While Staff does not recommend such an inclusion at this time, DVP's rebuttal testimony does recommend that such an adder be included in market prices for use in calendar 2003. DVP bases the calculation of the proposed adder on monthly capacity contracts only. DVP also conditions its offer to include a capacity adder on certain changes to its supplier tariffs which DVP states are necessary to make it “whole” in the event of supplier default after it has sold capacity necessary to serve retail customers formerly served by the defaulting supplier.

At the heart of this controversy is the appropriate value quantification of power displaced and made available for wholesale sale when a customer elects to take generation service from a CSP. DVP maintains that its traders can capture additional value from the sale of displaced capacity into the PJM monthly capacity market in excess of the value generated by assumed sale into the PJM- West and Cinergy forward markets for financially firm energy. DVP’s position is that the Act requires the inclusion of this incremental value in the calculation of Commission- determined market prices for generation and associated wires charges. Such inclusion will, other things being equal, raise the market price for generation and lower any indicated wires charges. This will serve to facilitate retail competition in Virginia by increasing CSP “headroom.”

The controversy associated with this proposal arises when considering the implications of DVP’s claim that, if the capacity adder is indeed added to the Commission determined market price, DVP’s traders will actually sell that capacity without recall. In this circumstance, such capacity will not be available if a CSP defaults on a supply obligation. In the alternative, DVP claims that if the capacity adder is not added to the market price, DVP’s traders will not sell that capacity and such capacity will be available if a CSP defaults on a supply obligation. Thus, DVP’s clearly stated position is that this Commission’s decision to include or exclude the capacity adder will, in fact, change the behavior of its traders.

According to DVP, should the Commission allow the capacity adder, DVP’s resulting sale of capacity into the PJM monthly capacity market exposes DVP to a risk that it is unwilling to bear. To mitigate those risks, DVP proposes certain changes to its CSP Coordination Tariff. Among the proposed tariff changes is a "Deficiency Charge" applicable to a defaulting CSP. In the event that appropriate recovery cannot be made from the defaulting CSP, DVP raises the possibility of collecting those revenues from non-shopping customers via its fuel factor. Staff objects to the suggestion that such revenues be collected in fuel charges as that would constitute, in Staff's view, a subsidy to shopping customers paid by non-shopping customers.

There is much to be said about this issue. First, the magnitude of the proposed capacity adder is small; CSPs have stated that it will not make a material difference in their decision to enter the Virginia retail market. Nevertheless, the adder is a step in the right direction and we commend DVP and Staff for raising the issue and placing it before us.

If the capacity adder is to be appropriately included in market price determination, the computation of the adder becomes an issue. Here, DVP has based the calculation on a monthly sale of displaced capacity that is triggered by this Commission's inclusion of the adder in the Commission-determined market price. If shopping customers no longer take generation service from DVP, that circumstance places another resource at the disposal of DVP's traders. To be sure, DVP's obligation to serve as a provider of last resort for those departed customers places constraints on DVP's ability to employ that resource as it seeks to produce value via its participation in wholesale energy markets. In reality, one should expect any wholesale power trading operation to maximize its risk-adjusted returns by managing all of its assets and obligations taken as a package. In other words, the amount of electrical energy and capacity "freed-up" by shopping customers represents risk adjusted[6] "resources" that may be put to work to satisfy business objectives.

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[6] In this instance, the risk is that shopping customers will return to the incumbent pursuant to the Act with or without CSP default.

DVP has placed before this Commission a proposed capacity adder based on a monthly capacity market. The assumed capacity sale on a monthly basis is a risk mitigation measure in and of itself made necessary since customers may return to the incumbent at any time irregardless of supplier behavior. The company proposes to further mitigate its risk by proposing certain tariff changes, finally backstopping its overall capacity adder proposal with the possibility of collection of costs associated with supplier default via the fuel factor.

It is clear that we cannot precisely determine the economic value of capacity "freed-up" when customers choose alternative suppliers for generation services. Nor can we precisely quantify the incremental business risk taken on by DVP with and without its proposed tariff changes. It may turn out that DVP's proposed tariff changes are unnecessary. For example, the actual market determined value of displaced capacity may more than compensate DVP for any increased risks that arise from including a capacity adder in the Commission-determined market price projection. In addition, DVP's proposed tariff changes are confusing and may have a chilling effect on CSP participation in the Virginia retail market. Finally, the inclusion of the proposed tariff changes in the rebuttal portion of this proceeding has limited the parties' and the Commission's evaluation of the requested tariff changes. For these reasons, we decline to adopt DVP's proposed tariff changes in this proceeding.

Although we decline to allow DVP's proposed tariff changes, we will allow – but not require – DVP to include a capacity adder in its proposed market prices for generation pursuant to the method set forth in DVP Witness Koogler's rebuttal testimony.[7] We again commend DVP for proposing the capacity adder, and DVP is not precluded from proposing risk mitigation measures in the future if such

[7] We will require that DVP notice the parties to this proceeding as to whether they will include a capacity adder in their compliance filing. Such notice will be required ten days after the date of this Order.

measures are shown to be necessary. Further, we direct the Staff to monitor all recallable and non-recallable sales of capacity made by DVP for the period beginning January 1, 2002, as well as the impact of those capacity sales on the DVP fuel factor.

Transmission cost adjustment for AEP-VA

The next issue in this matter concerns AEP-VA's transmission cost related adjustments to proposed market prices for generation. This issue is illuminated by a comparison of the methods used by DVP and AEP-VA to effect the required adjustment as set forth in their respective July 1, 2002, filings.

The Commission stated in its November 19, 2001, Order in this case:

> AEP lacks meaningful data on such transmission expenses because it has no actual experience with transmission costs incurred for displaced power in its pilot. We will require AEP to identify transmission costs, on a per kWh basis, paid to third party transmission suppliers, associated with off-system sales sourced by units that would otherwise serve Virginia jurisdictional load. It is the sale from these units that would be transmitted if AEP's Virginia customers choose a CSP under retail access. AEP shall develop proxy transmission cost data and file such on or before December 3, 2001, along with work papers that support its estimate.

We begin our discussion here with the question of AEP-VA's compliance with the prior Order set forth above. First, as AEP-VA witness Kelly D. Pearce explains, the numbers used to effect a transmission cost adjustment appearing in the December 3, 2001, compliance filing are identical to numbers used to effect the same adjustment in its July 1, 2002, filing. In that later filing, AEP-VA provides the following description of the transmission adjustment:

> On-peak transmission expenses are shown in Attachment 5, including class realizations, reflecting the estimate of the transmission expenses that would be incurred to deliver power, that otherwise would have been sold to Virginia retail customers, to either the Into Cinergy or PJM West delivery points. The transmission expenses include the Company's current OATT transmission charge and ancillary services 1 and 2. Such

> expenses are calculated based upon the current OATT charges to the Into Cinergy and PJM West delivery points.

The referenced Attachment 5 shows expenses derived by "pricing-out" transmission transactions at AEP's current OATT. There is no attempt to identify the particular plants that would, but for the supposed loss of retail customers, serve Virginia load. Nor was there an attempt to precisely determine the transmission expense of transmitting that power to the relevant market hub.

AEP-VA also failed to meaningfully net transmission revenues that accrue to AEP-VA when a CSP imports power via the AEP transmission system to serve newly won customers in AEP-VA's service territory. The result of this failure to net transmission expenses yields a transmission cost adjustment for AEP-VA that is in excess of 10 times larger than that of DVP. When asked to explain that difference, AEP-VA witness Pearce explained:

> A portion of those costs are being credited back to Appalachian, but the bulk of those costs are not being credited. They're not making their way back to Appalachian because of all the other parties in the pool. (Tr. 174)

Pursuant to § 56-583 A, the Commission adjusts market prices for the <u>net</u> cost of transmission required to send displaced power to distant wholesale markets. This means that the cost to reach the distant market is offset by revenues realized when the incumbent sells transmission service to the CSP that now serves the incumbent's former customer. DVP does indeed arrive at a net number by subtracting transmission revenues garnered from CSPs assumed to serve load lost by DVP. AEP-VA, however, does not net revenues assumed to be realized from CSPs purchasing transmission service against the cost of transporting power to the distant wholesale market.

Although not stated in the filing, it appears that AEP-VA's position is that such "in-bound" revenues are realized by AEP, not Appalachian Power Company, and as such are not correctly included in the calculation. The result of this is that the transmission adjustment for DVP is indeed a net adjustment and is very small (for example, for residential service: $0.31 per MWH), while the adjustment for AEP-VA is relatively large (for example, for residential service: $3.60 per MWH). The effect of this is to increase wires charges for AEP-VA (other things being equal) in the event that capped generation rates exceed Commission-determined market prices.

AEP-VA's transmission cost reduction to market prices is more than 10 times that of DVP's. This serves to increase any applicable wires charge and have a generally chilling impact on the prospects for the development of an effectively competitive retail market in Western Virginia. As stated above, the Commission adjusts market prices for the net cost of transmission required to send displaced power to distant wholesale markets pursuant to § 56-583 A. Accordingly, we will require AEP-VA to provide a detailed reconciliation of its proposed transmission cost adjustment to that of DVP. We will also require AEP-VA to identify the generation resources that would otherwise serve Virginia jurisdictional load, to quantify the transmission expense associated with actual transactions sourced from those units over the most recent 12-month period for which data are available, to account for the revenue flows that arise from those transactions, and to provide a detailed accounting of the transmission revenues that would be collected from transmission customers in the event that an AEP-VA customer elected to take service from a CSP. This information shall be filed as a part of AEP-VA's report supporting the market price determination for use in determining the wires charge.

Accordingly, IT IS ORDERED THAT:

(1) The generation market price methodologies for purposes of establishing wires charges for DVP and AEP-VA for 2002, as revised by the companies in this proceeding, are approved as modified herein.

(2) On or before November 1, 2002, DVP and AEP-VA shall file reports showing the results of their base market price calculations and authorized adjustments, with supporting data, and after load shaping for each rate class, the rate class specific market prices for generation. Each company shall adjust market prices for transmission expenses as required by our Order of November 19, 2001, in this docket.

(3) Incumbent electric utilities seeking to impose a wires charge in calendar year 2003 and beyond shall make annual filings by July 1 of each year for any proposed revisions in their fuel factor and corresponding changes in capped rates, and for market price proposals.

(4) DVP shall, within ten (10) days of the date of this Order, provide notice to the parties as to whether DVP will include a capacity adder in its compliance filing.

(5) This docket shall remain open for the receipt of reports to be filed herein and for consideration of other matters concerning market price determination and wires charges, as they may arise.